GCR South Africa Corporate Sector Risk Scores
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Related criteria and research

Criteria for the GCR Ratings Framework, May 2019
Criteria for Rating Corporate Entities, May 2019
Criteria for Rating Real Estate Investment Trusts and Other Commercial Property Companies, May 2019
GCR Ratings Scales, Symbols & Definitions, May 2019
GCR's Country Risk Score Report, March 2021
GCR's South Africa Corporate Sector Risk Score Report, July 2020

The GCR South African Corporate Sector Risk Assessment

GCR utilises the sector risk score in conjunction with the country risk score, to determine the operating environment risk score for each individual entity within the South African environment. The following sector risk scores are intended to provide users with an overview of the major factors that impact GCR's assessment of the relative risk of each sector in the local economy. The following list is not a comprehensive list of all sectors of the economy, but largely covers GCR's South African corporate rating universe. Additional sector risk scores will be introduced as necessary.

GCR will continue to monitor trends in the sectors contained in this publication and will update sector risk scores as the underlying factors shift.

Summary of changes since last review

The following risk scores have been updated since the last publication (July 2020)

- *Agriculture sector risk score raised to 4.5, from 4.0 previously*
- *Mining sector risk score raised to 4.0, from 3.5 previously*
- *State Owned Companies reduced to 6.0, from 6.5 previously*

South African Corporate Sector Risk Scores

Agriculture, Sector Risk Score 4.5 (previously 4.0)

The agriculture sector risk score reflects its inherently highly cyclical nature, with agro-industrial corporates' earnings and cash generation fluctuating widely due to exogenous factors including climatic conditions and commodity price volatility. Domestically, the sector is vulnerable to material disinvestment due to uncertainty in respect of the ongoing land redistribution debate, while an evolving labour landscape, water scarcity and broader environmental considerations remain key risk factors.

The Agricultural sector demonstrated the stability of demand engendered by its central position in the economic and social fabric of South Africa through the COVID-19 pandemic. Agricultural production grew in each quarter of 2020 (even in the second quarter which was impacted by the hard lockdown) and grew by 13% overall in 2020; agriculture was the only industry within South Africa to report positive growth in 2020. GCR expects the robust performance to continue into 2021, with many of the key agricultural regions experiencing favourable weather conditions and benefitting from firm agricultural commodity prices both in the local and international markets. Moreover, because of agriculture's essential nature and the more disparate spread of farms, the industry has proved to be less susceptible to disruption, even if further waves of COVID-19 infections materialise.

Construction and Engineering, Sector Risk Score 1.0 (previously 1.0)

GCR's sector risk score for the construction and engineering industry reflects the high cyclicality against low risk of substitution. Most significantly, industry risk is underpinned by the complex nature of work undertaken and relatively low margins that can be extracted. Thus, construction companies face the ongoing threat of delays and cost overruns, which can result in loss making contracts and substantial cash outflows. A gradual adoption of digital transformation is expected to increase operating efficiencies, thereby improving profit margins. Safety and environmental factors are also ongoing concerns which can lead to large, unexpected liabilities and damage the contractor's reputation.

The South African construction industry has evidenced a protracted decline in profitability over the past few years, due to a dearth of both private and public sector projects. This resulted in a decline in revenue and intense margin pressure, as contractors were forced to aggressively price for the limited tenders that did materialise. Financial challenges were exacerbated by a number of poorly performing contracts, which saw several large construction groups being placed into business rescue or facing severe financial constraints. COVID-19 compounded the underlying problems, with construction output declining by 20% in 2020, mainly as a result of the hard lockdown, followed by periodic disruptions thereafter. Construction activity was positive in 3Q and 4Q 2020 (off a low base), but GCR expects the industry to remain very weak until there is demonstrated, and meaningful, government-led infrastructure spend. The national government has prioritised infrastructure spend as part of its post COVID-19 economic stimulus package, but project implementation remains constrained by the weak national fiscal position.

Education, Sector Risk Score 7.0 (previously 7.0)

GCR's sector risk score for education reflects the industry's below average cyclicality and moderately high profitability through business cycles. Moreover, the industry evidences low environmental impact risk and moderately low risk of technological disruption, albeit that investment in ICT platforms enhances the learning experience, particularly in long distance and tertiary education, which is a distinct competitive advantage. Nevertheless, these factors are counterbalanced by intermediate barriers to entry which open the industry to potentially many competitors, which could impact industry margins. Further, while the regulatory and legislative environment is largely static, GCR would expect to see the resolution of the funding model for public institutions to bring stability to the tertiary segment.

Against the backdrop of severe capacity shortfalls and deteriorating education standards at public institutions, the attractiveness of private schools, particularly those targeting the mid and lower LSM market segments, continue to maintain a strong baseline of demand. That said, while education is considered a priority in most household budgets, private education costs can be a hindrance, and remain significantly higher than the cost of public schools. Affordability concerns have materialised through the COVID-19 pandemic, with private education providers reporting a meaningful increase in debtors and some attrition in student numbers. As such GCR expects enrolment in private institutions to remain stagnant over the short term. However, industry profit margin may be supported through sustainable operating efficiencies that have arisen from distance and e-learning platforms.

Fast Moving Consumer Goods ('FMCG'), Sector Risk Score 5.5 (previously 5.5)

The FMCG sector score is reflective of the stable profitability of the leading players in the South African industry and relatively moderate regulatory risks. Nevertheless, this is moderated by low barriers to entry and high susceptibility to product disruption. Rising consumer strain has, however, significantly curtailed pricing power in the South African FMCG industry over the past 18 months. Consumers have increasingly been downgrading from premium to more competitively priced brands, as a result of which producers have not been able to pass on the additional costs arising from input prices, as well as marketing and distribution expenditure.

The impact of COVID-19 for FMCG has been more moderate than in other sectors, albeit segments such as alcohol producers have been severely impacted by the ban on sales. Supply chains have been well managed and appear to be normalising, subject to some constraints on imported raw material. Nevertheless, most inputs into South African products are manufactured domestically, reducing such risks. While strong earnings growth is dependent on a broader recovery in the economy and in consumer confidence, GCR expects FMCG companies to report improved earnings in 2021.

Gaming, Sector Risk Score 4.5 (previously 4.5)

Gaming presents above average cyclicality globally, but in most jurisdictions the industry is insulated by considerable regulatory rigour, which translates to high entry barriers. As such, disruption and competition tends to have a much more measured effect than other hospitality and leisure formats. Nevertheless, the industry remains susceptible to illegal gambling, as well as evolving environmental, social and governance factors that could curtail footfalls and, to an extent, investment in the sector in the medium-term. That said, the South African gaming environment presents relatively strong baseline margins and is expected to show better earnings resilience through economic downturns than international destination markets due to its geographic insulation.

Gaming was significantly impacted by the national lockdown and the need for social distancing. Even as facilities have reopened, the operations remain constrained by limitations on capacity, the national curfew and at times the restriction on the sale of alcohol. As many gaming operations have been built around a more holistic entertainment offering, including restaurants, theatre and bars, the continued closure of many of these venues has further reduced foot traffic. Positively, regular players have been attracted back to casinos by stringent safety protocols, and promotional activity, but there remains a segment of potential customers that will not return until the pandemic passes.

To align with the curtailed operations, gaming operators have implemented significant cost cutting measures. This has ensured that casino properties can operate on a cash flow positive basis before accounting for finance costs and depreciation. Across the industry, capex projects have been placed on hold to conserve cash, whilst negotiating covenant waivers and term extensions on debt facilities. To date banks and other finance providers have been supportive, but risk will increase in the absence of a sustainable improvement in operations. However, industry performance remains highly susceptible to further waves of COVID-19, with revenue declining substantially when more stringent curfews and the alcohol ban are in place, as well as the greater reluctance of customers to go out. Accordingly, given the likelihood that COVID-19 disruptions could persist through most of 2021, GCR maintains a negative view on the sector.

Healthcare, Sector Risk Score 6.5 (previously 6.5)

GCR's sector risk score for Healthcare is reflective of the low cyclicality of the industry, as well as the stability offered by high barriers to entry, given the substantial capital and expertise required to open new facilities. This position is however, somewhat offset by high regulatory risk. In particular, increased regulatory scrutiny which will arise from the outcome of the healthcare enquiry is likely to have a negative impact on the already strained growth prospects for the large hospital groups in the domestic environment, as well as impeding pricing flexibility. Nevertheless, GCR does not expect the findings to present a material risk to the credit quality of the healthcare sector. The more systematic challenge remains the low levels of growth in medical scheme members and the potential disruption from the planned National Health Insurance system.

The underperformance of the South African private healthcare sector during 2020 was a direct result of the COVID-19 pandemic, due to the cancellation of all elective surgeries and generally lower admission levels, combined with higher costs associated with additional protective measures. Healthcare providers have since learned to better manage their facilities through the pandemic, with a strong 4Q 2020 reported. However, with the timing and efficacy of the vaccine rollout to the general population still vague, combined with predictions of a third wave of the virus, GCR considers the short to medium-term prospects of the sector to remain somewhat uncertain. Notwithstanding this, GCR expects an improved financial performance in FY2021, more stable debt levels, as well as some improvement in credit protection metrics.

General Hospitality, Sector Risk Score 4.0 (previously 4.0)

General hospitality presents above average cyclicality, with international trends reflecting overall vulnerability to regulatory changes and shifts in local, regional, and global macroeconomic trends. This is largely due to the discretionary nature of spending on hotels and general leisure activities, which compete for disposable income with other forms of non-critical spend. Hotels are especially susceptible to seasonality and exogenous shocks but do benefit from international tourism and are thus somewhat less vulnerable to weaknesses in the domestic economy. They also derive some stability from business tourism and conferencing volumes. The low entry barriers, however, point to higher competition, with susceptibility to substitution observed in certain pricing segments, as well as comparatively higher potential for disruption.

Notwithstanding the above long-term characteristics of the industry, the hospitality sector has been the most severely impacted by the COVID-19 crisis, due to the shutdown of global and regional travel. Numerous conferences and events have been cancelled, and only the most essential business travel is being undertaken. The impact continues to be felt more broadly than just the hotel industry, as airlines, safari operators, travel agents, tourist focussed attractions and restaurants all continue to suffer from the plunge in tourist volumes. Domestic tourism has helped some operators survive, but a return to the higher value international and business travel remains key. Positively, hospitality groups have fundamentally reduced their costs structures, which will allow them to break even at lower levels of occupancy, or at lower capacity, while supporting firmer operating margins when conditions in the industry normalise. Given the significant uncertainty as to the timing of any recovery in travel and the risk to long term financial sustainability under current conditions, GCR continues to have a negative outlook on the hospitality sector, albeit the weakness in the industry has been reflected in the multiple downward adjustments in the sector risk score during 2020.

Information Communication Technology ("ICT"), Sector Risk Score 5.25 (previously 5.25)

The ICT sector risk score reflects the industry's below average cyclicality, but high susceptibility to technology disruptions and import substitution. Moreover, the industry is impacted by low barriers to entry, with markets being generally fragmented. That said, the nature of products could provide an effective entry barrier if specific to the customer and/or patented. The market is generally characterised by competitive price pressure and discretionary spending patterns, although the domestic growth outlook remains positive.

GCR expects the ICT industry to emerge from the current pandemic stronger, as the crisis and the work from home routines implemented by businesses across the board have highlighted the importance of having a strong ICT backbone and electronic communication facilities. This should benefit players across the sector, from suppliers of technology hardware who will experience increased demand for upgraded products, to the large telecom providers who have seen usage of data services spike, as well as all the service providers who develop and maintain corporate networks. Nevertheless, there may be some disruption to established players as they are forced to adjust their business models to meet the ever-changing market requirements. For example, telecoms infrastructure providers are shifting towards data provision, from their previous focus on voice communication and network administrators are required to provide comprehensive cloud-based solutions, rather than managing physical office networks. Accordingly, GCR expects there to be substantial earnings variability amongst the players in each of the various niches.

Logistics, Sector Risk Score 4.5 (previously 4.5)

GCR is of the view that the Logistic sector presents above average cyclicality and very low barriers to entry. Given the intense competition, the industry generally operates on very thin margins, although operators in more specialised niche transport fields can command higher prices. Longer term trends appear positive as many entities move to outsource their logistics functions to optimise costs, as supply chain management increases in complexity.

While overall volumes remain constrained by COVID-19, the impact has not been material on the larger industry players. This is because many segments of the industry are classified as essential services or support essential services. This includes port operators, rail, and freight, where demand remains resilient. Accordingly, GCR would expect operators in the broader sector to continue to benefit from the long-term growth trends in the industry. Passenger transport operations have, however, suffered significantly from the reduction in all forms of travel and the outlook for such companies depends on the extent of the recovery in this market. This distinction also extends to the financial sustainability of the industry, considering the high gearing levels that are inherent to the fleet leasing arrangements common in the industry. GCR expects logistics players in the broader sector to be able to withstand temporary liquidity pressures, but several players in passenger transport have been forced into business rescue or liquidation because they can no longer operate profitably and meet their debt obligations.

Primary Manufacturing, Sector Risk Score 3.5 (previously 3.5)

GCR's sector risk score for Primary manufacturing weighs the high cyclicality of the industry against the stability offered by fairly high barriers to entry and relatively low vulnerability to technology disruptions, given the substantial capital investment required in manufacturing plants and significant scientific knowledge required to operate effectively. This position is, however, somewhat offset by high regulatory and environmental risks, as well as the susceptibility to labour disruptions.

COVID-19 disruptions have had little impact on the primary manufacturing sector due to the essential nature of many segments, as well as the long-term nature of supply contracts. Fundamental challenges such as subdued domestic demand, higher electricity tariffs and rising fuel prices remain significant constraints on the ability of domestic manufacturers to drive revenue growth. This notwithstanding, the implementation of cost saving and efficiency improvements (even prior to COVID-19) has served to strengthen the competitive positions of domestic companies. Moreover, GCR would expect to see some volume growth in South Africa's primary manufacturing sector if key customer industries such as agriculture and mining continue to outperform.

Secondary Manufacturing, Sector Risk Score 3.5 (previously 3.5)

GCR's sector risk score for secondary manufacturing reflects the industry's above average cyclicality and high susceptibility to technology disruptions. Moreover, the industry is impacted by regulatory and environmental concerns, as well as ongoing labour pressures. Most significantly, secondary manufacturing's profitability has been impaired by rising costs (particularly electricity and wages), which have exacerbated the pricing pressures already faced through import substitution. Thus, many secondary manufacturers have ceased operation in recent years, while many of those that continue exhibit weak margins.

Positively, the COVID-19 crisis may provide an opportunity for local manufacturers to regain market share which had been lost to imports in recent years, as the current logistical challenges highlight the risk to South African corporates of being too dependent on imports. The national government's statements with regard to promoting job creation by establishing a more conducive environment for domestic manufacturing activity is also positively considered. Nevertheless, GCR would expect to see measurable progress in creating a more supportive regulatory and political environment before this can be considered in support of raising the South African manufacturing sector risk score.

Mining, Sector Risk Score 4.0 (previously 3.5)

GCR's sector risk score for Mining weighs the high cyclicality of the industry against substantial barriers to entry, low risk of substitution and slow adoption of technological changes domestically. For several years the industry has been under strain due to electricity price increases, labour tensions and regulatory and political interference. However, there are indications that measures taken to combat these challenges have improved the operating fundamentals of mining companies, with the industry emerging from the disruptions of 2020 in a strong position.

Whilst overall production volumes were around 11% lower in 2020, due first to the COVID-19 lockdown and thereafter to capacity limitations, production volumes improved steadily through 2H 2020. The industry benefitted from renewed cooperation between the mining houses, government, and labour in returning mines to operations. More significantly, the value of output was bolstered by robust prices across the range of locally mined commodities. With operating efficiencies having been greatly enhanced over recent years, domestic mining companies reported very strong results for the period to December 2020. These excess cash flows have been used to repay debt, with gearing levels having decreased substantially over the past 12 months

The positive conditions have continued into 2021, with gold and platinum group metals trading at or close to multi year highs. Accordingly, several mining houses have indicated that they are considering large investment projects, which could support the longer-term prospects for the domestic industry. Although delays and uncertainties in the granting of licences, combined with further steep electricity price hikes remain inherent risks, GCR expects robust cash flows to continue over the short to medium-term, which will support further improvements to the financial profile of the industry.

Property, Sector Risk Score 6.0 (previously 6.0)

GCR considers the property sector to evidence moderate risk characteristics, supported by below average cyclicality, assets that generate strong income through the cycle, and sustained demand for well-positioned properties. Despite these inherent advantages, the South African property sector has stagnated somewhat over the past 24 months. Even prior to COVID-19 the industry was reporting rising vacancies and lower rental reversions, placing pressure on asset valuations. In the listed property space, much lower share prices (well below reported NAV) due to depressed equity markets, as well as repricing on the debt capital market, led to a deterioration in access to capital. COVID-19 exacerbated many of these challenges. Assumptions regarding the stability of income were challenged as many tenants withheld rentals due to them not being able to trade, which required property owners to withhold distributions to investors.

While collection rates have recovered across the property sector, those properties exposed to tenants in the hospitality and entertainment sectors remain under severe pressure. Accordingly, property owners have been required to maintain rental relief agreements with these tenants, albeit that overall relief granted is currently much lower than during 2020. Vacancies remain a major challenge, with many tenants downsizing or going out of business during the pandemic. The disruption to the industry caused by the shift towards working from home adds further uncertainty to the industry. GCR would thus expect property sector earnings to remain weak over the short to medium term, with the longer-term trajectory to be dependent on how property owners adjust the usage of their properties to meet the requirements of tenants and customers.

With the decrease in income and property valuations, covenant risk has increased. To date, banks have largely been supportive of the property industry, granting covenant waivers and debt extensions were needed. However, debt funding headroom remains limited, and other liquidity sources such as assets sales are taking long to materialise. Amidst these challenges GCR expects conservatively leveraged funds to evidence much greater resilience, whilst those funds with shorter term debt maturities and limited access to capital will likely face more onerous refinancing terms.

State Owned Companies, Sector Risk Score 6.0 (previously 6.5)

The sector risk score for State Owned Companies ('SOC') is underpinned by their low cyclicality and very high barriers to entry. Specifically, most SOCs operate as implementing agencies for government policies and do not face competition, in many cases being the only entity allowed to provide such a service. This is marginally offset by labour risks, which arise as a result of the strength of public sector unions, as well as potential environmental concerns, given the fact that many operate in the infrastructure space. Most importantly, the score is constrained by the financial dysfunction affecting many of these companies, underpinned by very high levels of debt and persistent operating losses.

GCR's view is that the assurance of financial Support for SOCs from the South African Government has become much less consistent. This has been highlighted most clearly by the relatively restrained government support for the Land Bank, despite its importance to the SA economy, in contrast to SAA which has received financial support well in excess of what was guaranteed, even though there are many private players that can fulfil its role. Moreover, even prior to the COVID-19 pandemic, the national government was facing a weakening economy, reduced tax revenue and the need to cut back on certain capital investments, calling into question its ability to provide financial support to various entities. The COVID-19 pandemic significantly exacerbated these weaknesses in the economy, with the February 2021 budget indicating lower grants to most areas of operation and investment. Accordingly, GCR's assessment of the government support is tempered by weighing up the social importance of the entity, against the structures of ongoing financial support and actual quantum of debt outstanding, as well as the consequences if timely support is not forthcoming.

Discretionary Retail, Sector Risk Score 4.5 (previously 4.5)

Discretionary retail depicts above average cyclicality, as volumes are more susceptible to variability through the cycle, while the ability to make timely cost pass-throughs are considerably diminished during periods of price deflation, heightened competitive pressures, or declining demand. Retailers generally benefit from low regulatory oversight and limited environmental considerations, albeit barriers to entry are also low. That said, the potential to achieve effective supply chain management, relative cost flexibility and moderately low levels of disruption, together with high levels of consumerism amongst a largely urbanised population with access to credit enables the industry to reflect some stability and to achieve cross-cycle profitability despite the observed demise of some mid-top tier players.

Contrary to expectations that weak disposable income would depress the performance of discretionary retailers, there has been very strong consumer demand. Categories such as hardware, household furniture and appliances evidenced consistent growth through 2H 2020, compared to the weak or negative growth in other retail categories. The one segment of discretionary spend that did suffer was fashion and jewellery. This development reflected a shift towards spending time at home, and thus greater focus on the quality of the household, compared to socialising which drives demand for fashion items. While GCR expects this trend to continue to support demand for discretionary retail, the very strong growth is likely to subside as householders complete their renovations and purchases.

Non-discretionary Retail, Sector Risk Score 6.0 (previously 6.0)

GCR is of the view that FMCG retailers continue to present below average/average cyclicality and relatively sound cash flows, on the back of largely non-discretionary, high repeat business volumes. While relatively low barriers to entry, limited regulatory oversight and low environmental risks increase the potential for competitive pressures to curtail margins, industry stability is supported by extensive supply chain infrastructure, including entrenched relationships with suppliers and relative cost flexibility (including the optimisation of space to mitigate rising all-in occupancy costs) which typically underpin the strong market positions achieved by a small number of top-tier players.

Non-discretionary retailers have been able to trade through the COVID pandemic with only limited restrictions. However, trading levels were somewhat muted, with growth falling below inflation. Non-discretionary retail performance was partly constrained by the ban on alcohol sales for a large part of 2020. However, most domestic non-discretionary retailers had strong balance sheets leading into the COVID crisis, which continue to insulate them from funding pressures. Accordingly, GCR does not anticipate credit challenges in this sector but earnings will likely remain somewhat constrained.

Figure 1: GCR South Africa Sector Risk Ranking